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The Director of Central Intelligence

Washington, D.C. 20505

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National Intelligence Council

NIC #01239-87/1
26 March 1987

MEMORANDUM FOR: Distribution

FROM: Carl W. Ford, Jr.
National Intelligence Officer for East Asia

SUBJECT: East Asia Warning and Forecast Meeting - 18 March 1987

1. Attached is my report to the DCI based on our meeting held on 18 March 1987. Please let me know if there are any significant amendments, additions, or corrections.

2. Next month's Warning and Forecast Meeting will be held Wednesday, 22 April 1987 at 1400 hours in Room 7E62, CIA Headquarters. Recommendations for discussion/warning topics should be forwarded to this office by COB 13 April 1987.

3. It is essential that you telephone your attendance intentions to and have your clearances verified to us by your security office by NOON, 21 April 1987. Attendees from outside agencies are advised to arrive early to avoid parking problems created by construction work. Please enter the compound through Gate 1, the Route 123 entrance.

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Carl Ford
Carl W. Ford, Jr.

Attachment

18 March 1987 Warning Report

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The Director of Central Intelligence
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NIC #01239-87
26 March 1987

MEMORANDUM FOR: Acting Director of Central Intelligence
VIA: National Intelligence Officer for Warning
FROM: Carl W. Ford, Jr.
National Intelligence Officer for East Asia
SUBJECT: 18 March 1987 East Asia Warning and Forecast Report

1. The purpose of the March Warning Meeting was to compare economic reforms in China with those in the USSR and Eastern Europe. Presentations were made on each area, and the general discussion compared and contrasted the various reform programs.

Eastern Europe

2. [REDACTED] (EURA) outlined the reform program in Eastern Europe. Economic reform has essentially stalled in Eastern Europe for several years. In the 1970's, a number of Eastern Europe countries were implementing reforms, but these have stagnated. The reforms of China and the Soviet Union are now more dynamic and interesting than those of Eastern Europe. This is not to say that Eastern Europe has lagged behind the USSR and China; in fact, Eastern Europe may still be ahead. However, the bloom has gone out of reform.

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3. The reasons that reform has stagnated include:

- Governments refuse to accept unemployment and bankruptcy.
- They also refuse to eliminate subsidies in areas such as energy and housing.
- Party control is too strong at all levels of the economy.
- Bureaucrats, afraid of losing power and perks, resist change.
- Aging leaders, once reformers, have become less receptive to change.
- Ideological constraints hamper acceptance of wider income distribution.
- Many of them have not worked as well as hoped.

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4. The result is that the performance of non-reforming countries in Eastern Europe have performed better than those that have. For example:

- In Hungary reforms have been conducted off and on since 1968; the overall result has been a weak performance and stagnation. Income distribution has become a key issue, as has how to provide for poor and retired people. A group of 35 prominent economists have proposed a plan for much more dramatic and far-reaching reform which they believe is the only way to turn the Hungarian economy around. However the plan will not likely be approved; central authorities will still determine prices, investments, and other key features of the economy. The results are not promising.
- In Poland reforms were initiated in 1980, but they have been undermined by the edicts of martial law. The elimination of subsidies has not been accomplished, for example. The government has been fearful that reform could exacerbate political unrest.
- In East Germany and Romania there has been no reform. Ceaucescu has clamped down on the economy. The East Germans have a strong vertically integrated economy and no decentralization is planned.
- In Czechoslovakia there have been no reforms since 1968; nevertheless, the Czech leaders are closely watching the Soviet reforms under Gorbachev and may take some steps towards reforms if the Soviet results seem favorable.

5. The economic situation in Eastern Europe is bad and all countries recognize they have problems. Soviet reforms may provide a strong impetus for further reform in Eastern Europe. The Soviets have had mixed feelings about those Eastern European countries that have introduced reforms in the past, with some leaders seeing them as a model for the USSR, while others rejecting their reforms as "out of line." Now that Gorbachev is calling for political reform in addition to economic reform, there could also be greater momentum for reform in Eastern Europe.

Soviet Union

6. [REDACTED] SOVA, discussed the reforms Gorbachev seeks to implement in the Soviet Union. Gorbachev characterizes his proposals as a "revolution" and says he will pursue them in spite of potential opposition. However, he has been unspecific about his economic reform goals.

7. Gorbachev has accomplished some things. Central coordinating bodies have been established at various levels--above the ministries--to try to coordinate policies. A state agro-industrial commission will try to combine the functions of several ministries. Laws and statutes provide for greater freedom for enterprise managers. He is pushing for wage reforms which would tie increases to improved performance. Finally, he is promoting greater encouragement of the private sector.

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8. What are the implications of the reforms thus far? If we were to establish a scale with (1) representing the Stalinist economic model and (5) representing free market socialism the measurement for various categories would be something like this:

- On production decisions - (2). Production decisions are still essentially controlled by the state, but there is somewhat better management of these decisions.
- On measuring success - (2). The most reliable indicator of success is profit, but this remains an anathema in the Soviet Union. Instead, the measurement is principally improvements in contract fulfillment.
- On the wholesale supply system - (2). The state role is still one of control, but there is now more contracting out rather than operating strictly according to a state plan.
- On enterprise financial systems - (3). Enterprises now have more leeway in areas such as investing in enterprise renovation, obtaining bank credits, and in increasing wages. Nevertheless, there continue to be problems with linking wage increases and bonuses with performance and production increases.
- On the operation of the private sector - (2). Here the Soviets have expressed good intentions, but many restrictions are evident; the private sector is limited strictly to certain types of output.

9. One of the key problems for reform is the issue of price controls; unless price reform is undertaken, the impact of other reforms will be significantly lessened. The same obstacles noted in Eastern Europe also apply. Overall, the Soviet economy will likely remain at a (2) unless a perception of cataclysmic failure spurs a more radical reform effort.

10. During the discussion, several key points were made:

- In the USSR, the sectors which are receiving the most attention by reformers are state industry and agriculture.
- Many Soviet workers are unsympathetic with reform; rather than seeing benefits for themselves, they see benefits for workers other than themselves which they view negatively.
- If these reforms do not work, the Soviets have other options; they are not forced into a choice between either reforming or not reforming.
- The Soviets are watching the Chinese reforms with some interest as are the Eastern Europeans. To some degree the Chinese reforms have a negative influence on the Soviets since the Soviets perceive that serious difficulties have arisen.

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Chinese Reforms

11. [] OEA, discussed the Chinese reforms. A similarity between China and the other two cases is that rhetoric about reform has invariably exceeded actual implementation. One advantage that the Chinese have had is that the reforms were born out of the chaos of the Cultural Revolution. Maoism didn't work, and the Chinese had nowhere to go but up. Additionally, the Chinese have not had a predetermined strategy or plan; they have moved along pragmatically, adjusting to fit the situation. For example, in reforming rural agriculture they did not plan a "revolution." They intended to establish a brigade contracting system rather than a household responsibility system. Yet the unleashing of rural productive forces and the success in raising rural income pushed them to go even further than they had intended.

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12. China has many of the same problems as does Eastern Europe. The Party interferes at the factory level. The government role has been reduced, but the Chinese are finding it extremely difficult to dissolve the role of the Party. Factory managers do not have genuine autonomy, and it has been very difficult to get reform policies implemented. For example, when some factories adopted a stock ownership system and set up boards of directors, Party secretaries managed to get themselves elected to the boards and retained their controlling influence.

13. There is agreement in China on the need for reform, but disagreement over how far reform should go. The reformers are trying to set precedents that will serve as guideposts. For example, after deciding to accept unemployment and enacting a bankruptcy law, China allowed one state factory to go bankrupt thereby establishing a precedent. Also, new workers are hired on 5 year contracts rather than being guaranteed lifetime employment as has been the past procedure.

14. A major hurdle for China, as with the other cases, is price reform. State controls on prices prevent calculations of enterprise efficiency. Wage reforms are also needed. Yet, decontrolling prices would result in price increases, inflation, and would be politically controversial.

15. The success of agricultural reforms has had some spinoffs which could become problems. Rural dwellers now want to produce higher income products than grain, and grain production has declined since 1984 (though better in 1986 than in 1985). Many rural dwellers are also setting up small industries for additional income. Some leaders believe that these tendencies are undesirable and would like to rein in the reforms.

16. There are some key differences between China and Eastern Europe. Besides a greater willingness to accept unemployment and bankruptcy, the Chinese have had much greater success in agriculture and some areas such as coal and steel production. For example, only about 40 percent of coal production and a similar percentage of steel production are produced under state plans.

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17. The reforms are now undergoing a period of retrenchment. Between March and December of 1986 the reformers were on a roll. They were able to set up a stock market, pass a bankruptcy law, enact unemployment insurance, and open up a wide debate on future economic policy. Since the overthrow of Hu Yaobang, however, those who have been less sympathetic to reform, or who believe the reforms have gone too far, may now be in the ascendancy.

18. The ensuing discussion brought out the following main points:

- There is uncertainty over whether or not the Chinese will be able to maintain current reform policies. Some analysts believe that although the reforms will slow down, they will continue; others believe some reforms may be reversed.
- In rural areas the agricultural reforms have been the key ingredient in raising household income. However, there are some signs of difficulty; many of the rural industries are highly inefficient, the population growth rate will probably begin to increase, and other problems are cropping up. Should these economic questions become entangled with political issues the results could be explosive.
- China hopes the service sector will absorb huge numbers of urban and rural unemployed. Whether this will work remains to be seen.
- There is uncertainty over the degree to which the power struggle now going on in China is independent of economic reform. In one view, the power struggle is largely independent, but in another view, the power struggle centers around reform issues.
- China's overall performance in 1986 was better than 1985.

Warning Implications

19. The experiences of Eastern Europe and the Soviet Union show that China's economic reforms are likely to encounter serious difficulties in the future. The current power struggle over the succession to Hu Yaobang could overshadow reform efforts. At best, we should anticipate that--in spite of Chinese assurances to the contrary--the reforms will slow down. The full implications of this for the United States are uncertain--the Chinese are also doing their best to assure us that their opening to the outside world will continue--but there could be continuing difficulty for US economic interests such as investment, negotiating a bilateral investment treaty, resolving textile issues, and other trade and economic questions.



Carl W. Ford, Jr.

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